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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION
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Arizona Corporation Commission

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IN THE MATTER OF THE COMMISSION'S
GENERIC EVALUATION OF THE
REGULATORY IMPACTS FROM THE USE
OF NON-TRADITIONAL FINANCING
ARRANGEMENTS BY WATER UTILITIES
AND THEIR AFFILIATES.

DOCKET NO. W-00000C-06-0149

NOTICE OF FILING

At the workshop held on March 25, 2011, Staff presented a PowerPoint slide show presenting its position on the issue of whether to impute income tax expense for utilities organized as business entities that do not incur income tax liability. Staff hereby provides notice of filing the PowerPoint slide show that Staff presented at the workshop.

RESPECTFULLY SUBMITTED this 30th day of March, 2011.

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**Original and thirteen (13) copies
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30th day of March, 2011, with:**

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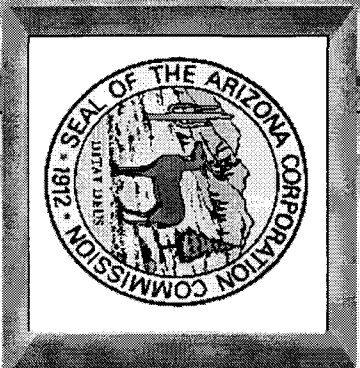
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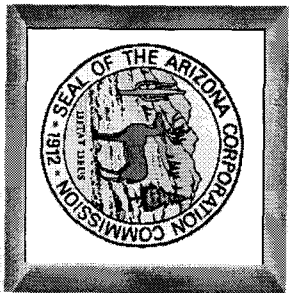
Compliance with Decision No. 71878

Imputed Income Taxes

Utilities Division

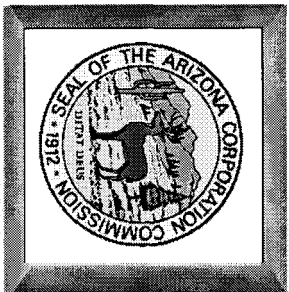
ARIZONA CORPORATION COMMISSION

March 25, 2011



The Issue

**Should income tax expense be imputed
for utilities that choose a form of
business entity that does not incur an
income tax liability?**



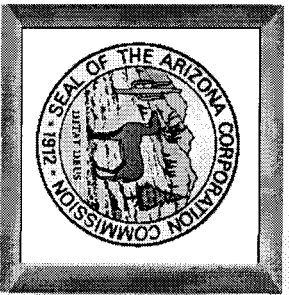
Pass-through Taxation

- “Pass-through” or “Flow-through” entities
- The income or loss of a non-taxable business entity is “passed through” to the individual owners, shareholders, or interest holders and reported on their individual tax returns.



Common Business Forms

- C-Corporation
- S-Corporation
- Limited Liability Company
- Sole Proprietorship
- General Partnership
- Limited Partnership
- Trust, Estate, Not-for-Profit, Cooperative, Association, Real Estate Investment Trust

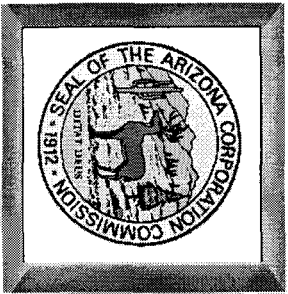


Considerations in Choosing a Business Form

- **Ownership**
- **Liability**
- **Tax Treatment**
- **Ease of Formation/Formalities**
- **Management Control**
- **Capital Needs**

Selecting the Right Business Structure: Comparison Chart of Different Forms of Business Entities

Characteristic / Entities	Ownership Rules	Personal Liability of the Owners	Tax Treatment	Key Documents Needed for Formation	Management of the Business	Capital Contributions
C Corp	Unlimited number of shareholders allowed, no limit on stock classes	Generally no personal liability of the shareholders for the obligations of the corporation	Corporation taxed on its earnings at the corporate level and the shareholders have a further tax on any dividends distributed ("double taxation")	Articles of Incorporation Bylaws Organizational Board Resolutions Stock Certificates Stock Ledger	Board of Directors has overall responsibility and officers have day-to-day responsibility	Shareholders typically purchase stock in the corporation, either common or preferred
S Corp	Up to 75 shareholders allowed, only one basic class of stock allowed	Generally no personal liability of the shareholders for the obligations of the corporation	Entity generally not taxed, as the profits and losses are passed through to the shareholders ("pass-through taxation")	Articles of Incorporation Bylaws Organizational Board Resolutions Stock Certificates Stock Ledger IRS & State S Corporation	Board of Directors has overall responsibility and officers have day-to-day responsibility	Shareholders typically purchase stock in the corporation, but only one class of stock is allowed
Limited Liability Company	Unlimited number of "members" allowed	Generally no personal liability of the members for the obligations of the business	Entity not taxed (unless chosen to be taxed), as the profits and losses are passed through to the members	Articles of Organization Operating Agreement	The operating agreement sets forth how the business is to be managed—a Manager can be designated to manage the business	The members typically contribute money or services to the LLC and receive an interest in profits and losses
Sole Proprietor	One owner	Unlimited personal liability for the obligations of the business	Entity not taxed, as the profits and losses are passed through to the sole proprietor	DBA filing	Sole proprietor manages the business	Sole proprietor contributes whatever capital needed
General Partnership	Unlimited number of general partners allowed	Unlimited personal liability for the general partners for the obligations of the business	Entity not taxed, as the profits and losses are passed through to the general partners	General Partnership Agreement Local filings if partnership owns real estate	The general partners have equal management rights, unless they agree otherwise	The general partners typically contribute money or services to the partnership and receive an interest in profits and losses
Limited Partnership	Unlimited number of general and limited partners allowed	Unlimited personal liability for the general partners for the obligations of the business; limited partners generally have no personal liability	Entity not taxed, as the profits and losses are passed through to the general and limited partners	Limited Partnership Certificate Limited Partnership Agreement	The general partner manages the business, subject to any limitations of the Limited Partnership Agreement	The general and limited partners typically contribute money or services to the partnership and receive an interest in profits and losses



Income Tax Treatment

- C-Corp: taxable
- S-Corp: flow-through
- LLC : flow-through
- Sole Proprietor: flow-through
- General Partnership: flow-through
- Limited Partnership: flow-through



IRS.gov: Starting a Business Business Structures

“When beginning a business, you must decide what form of business entity to establish. Your form of business determines which income tax return form you have to file. The most common forms of business are the sole proprietorship, partnership, corporation, and S corporation. A Limited Liability Company (LLC) is a relatively new business structure allowed by state statute. Legal and tax considerations enter into selecting a business structure.”

<http://www.irs.gov/businesses/small/article/0,id=99336,00.html>



IRS.gov: Starting a Business

Business Taxes

“The form of business you operate determines what taxes you must pay and how you pay them. The following are the four general types of business taxes.

- Income Tax
- Self-Employment Tax
- Employment Taxes
- Excise Tax.”

<http://www.irs.gov/businesses/small/article/0,id=98966,00.html>



IRS.gov: Sole Proprietor

“A sole proprietor is someone who owns an unincorporated business by himself or herself. However, if you are the sole member of a domestic limited liability company (LLC), you are not a sole proprietor if you elect to treat the LLC as a corporation.”

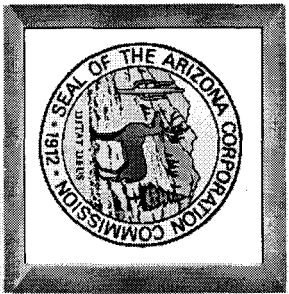
<http://www.irs.gov/businesses/small/article/0,id=98202,00.html>



IRS.gov: Partnerships

“A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it “passes through” any profits or losses to its partners. Each partner includes his or her share of the partnership’s income or loss on his or her tax return.”

<http://www.irs.gov/businesses/small/article/0,id=98214,00.html>

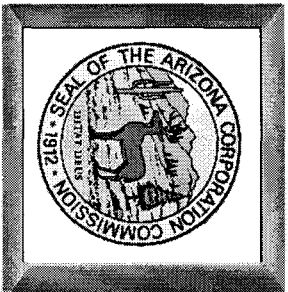


IRS.gov: C-Corporations

“A C corporation is recognized as a separate taxpaying entity. A corporation conducts business, realizes net income or loss, pays taxes and distributes profits to shareholders.”

“The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a double tax. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.”

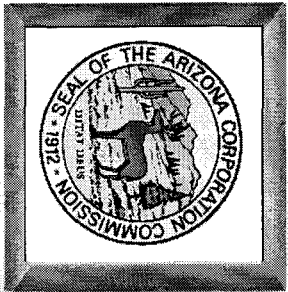
<http://www.irs.gov/businesses/small/article/0,id=98240,00.html>



IRS.gov: S-Corporations

“S corporations are corporations that elect to pass corporate income, losses, deductions and credit through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income.”

<http://www.irs.gov/businesses/small/article/0,,id=98263,00.html>



IRS.gov: LLCs

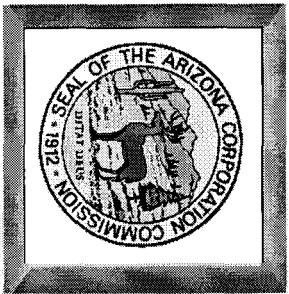
“The federal government does not recognize an LLC as a classification for federal tax purposes. An LLC business entity must file as a corporation, partnership or sole proprietorship tax return.”

<http://www.irs.gov/businesses/small/article/0,,id=98263,00.html>



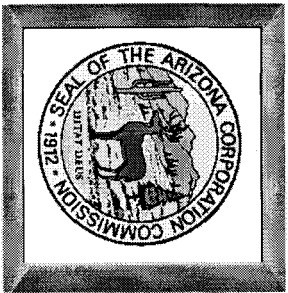
Classification of LLCs

- An LLC that is not automatically classified as a corporation can elect its business entity classification.
- At least 2 members: can choose to be classified and taxed as a corporation or a partnership.
- A single member: can choose to be classified and taxed as a corporation or disregarded as an entity separate from its owner, a “disregarded entity.”



Conclusions

- The form of business entity and, therefore its tax treatment, is a choice made by the organizers/owners.
- A flow-through entity incurs no tax liability; the income or loss passes to the individual owners who are assessed taxes at their individual tax rates.



Conclusions

- Owner's personal tax liability is not an expense incurred by the utility in the provision of service.
- Pro forma adjustment to include income tax expense in the rates of a pass-through is not appropriate.